State of New Mexico
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LFC INVESTMENT REPORT FOR THE QUARTER ENDING SEPTEMBER 30, 2014

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by these agencies differed from that of the archetypical fund and how management and consultants added or subtracted value. Because long-term performance is an important metric, this report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and attribution analysis for the quarter, one, and three-year periods.

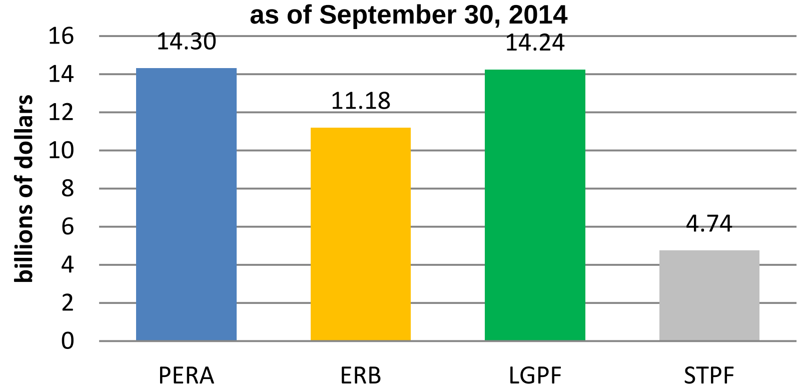
Market Environment

- The third quarter of 2014 found global stock and bond markets struggling to maintain gains from the previous quarter as investors were faced with numerous geopolitical events. Also looming large was the coming end to the Federal Reserve's third round of quantitative easing.
- The U.S. stock market, represented by the Wilshire 5000 Total Market Index, was basically flat for the third quarter, up 0.08 percent. Only a strong August prevented the first down quarter in two years as the market lost ground in both July and September. Energy stocks were hurt by lower oil prices, in part driven by weak economic indicators from China and the euro zone.

Returns and Ending Balances. Figures 1 through 4 show the ending balance and the returns for the quarter and for the one, three, five, and ten-year periods ending September 30, 2014. The one, three, and five-year returns exceed the investment agencies' respective annual targets, which are 7.5 percent for SIC and 7.75 percent for ERB and PERA. Ten-year returns fall short of long-term targets because they reflect lesser investment performance during the global financial crisis, exacerbated by asset allocations that did not include diversification through alternative investments given policy restrictions at the time.

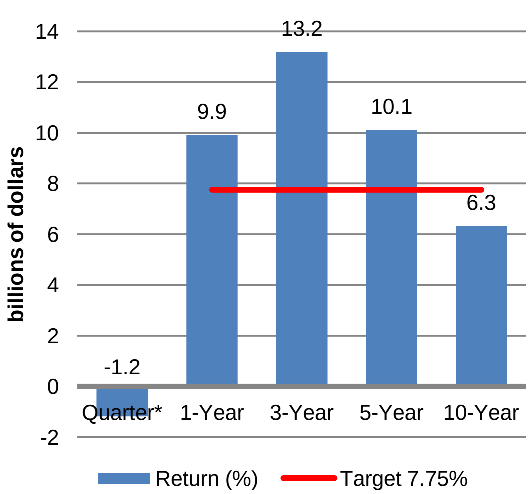
Figure 1 shows the quarter-ending balances of the major investment funds. The Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are managed by SIC and therefore shown separately. A portion of the STPF is invested in economically targeted investments (ETIs) that typically perform below-market because the investments are not targeted solely at delivering returns. SIC claims ETIs' reduced levels of expected financial return are justified in statute by the expected economic development benefits that the investment is expected to deliver. The LGPF does not have ETIs in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Figure 1. Ending Fund Balance as of September 30, 2014



Source: Agency Investment Reports

Figure 2. PERA Total Portfolio Returns as of September 30, 2014



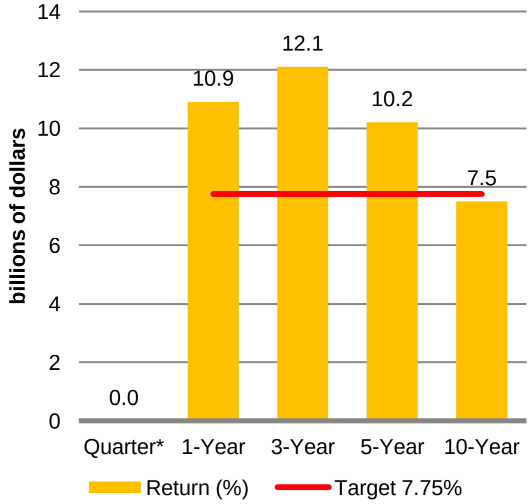
Source: Agency Investment Reports
*not annualized

Investment Policy Objectives.

PERA's investment policy establishes the fund's primary objective is to prudently invest assets in order to meet statutory obligations to its members. The fund's assets are managed to reflect its unique liabilities and funding resources, incorporating accepted investment theory, prudent levels of risk and reliable, empirical evidence. Specifically, PERA's board has adopted the following principles:

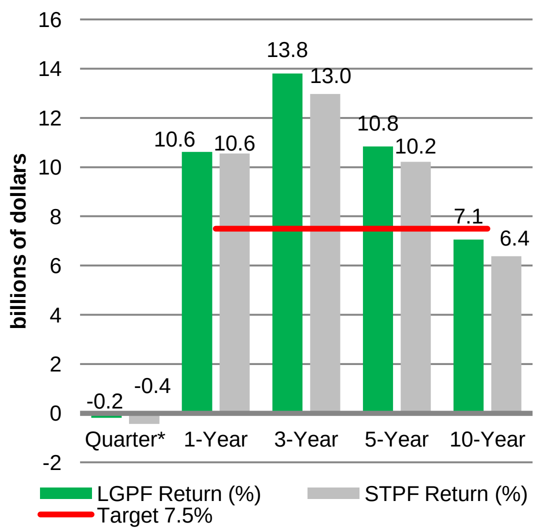
- Strategic asset allocation is the most significant factor influencing long-term investment;
- Risk is unavoidable;
- Diversification both by and within asset classes is the fund's primary risk control element;
- The fund's liabilities are long term and the investment strategy must therefore be long-term in nature; and
- Sufficient liquidity will be maintained to meet anticipated cash flow requirements, including payments to beneficiaries.

Figure 3. ERB Total Portfolio Returns as of September 30, 2014



Source: Agency Investment Reports
*not annualized

Figure 4. SIC Permanent Funds Portfolio Returns as of September 30, 2014



Source: Agency Investment Reports
*not annualized

ERB's investment philosophy and techniques are based upon a set of widely accepted investment models. The investment philosophy is summarized as follows:

- Develop and maintain strategic asset allocation (SAA) targets and ranges that optimally attain objectives of return and risk;
- When appropriate, ERB seeks to profit from capital market inefficiencies and market dislocations that may occur periodically;
- Investment positions take trading costs into consideration;
- Monitoring of investments and asset managers is a good administrative practice;
- Performance measurement and attribution analysis are essential in assessing effectiveness of investment strategies; and
- Rebalancing of the fund's assets is necessary for attainment of investment objectives.

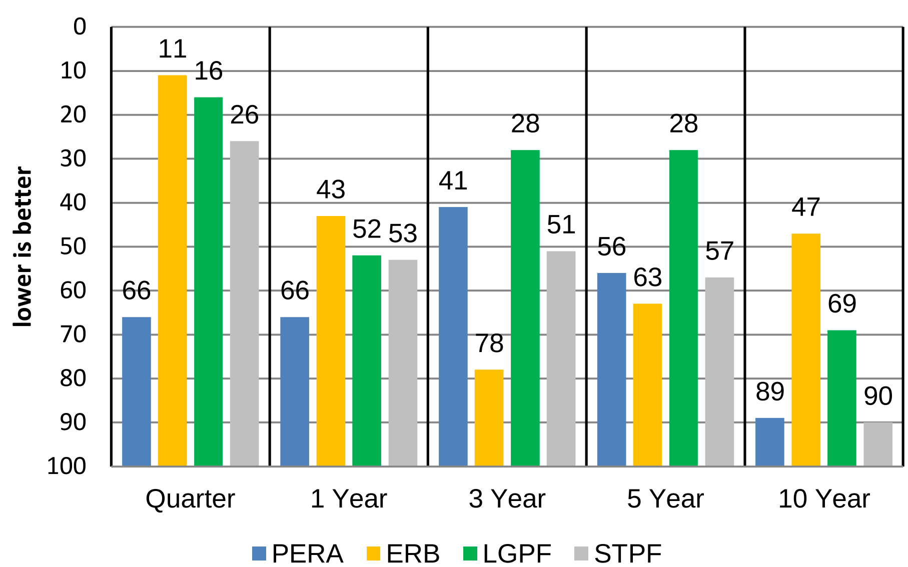
SIC's investment goals are to preserve the permanent endowment funds and to provide both current and future benefits by growing the funds at a rate at least equal to inflation. SIC seeks to manage the funds to ensure that future generations receive the same or greater benefits as current beneficiaries, while maximizing current distributions through time to provide current revenue sources to the state's general fund. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the funds. In order to meet the investment objective, the SIC has adopted the following principles:

- To preserve the purchasing power of the corpus and to provide benefits, the funds should have a long-term strategic asset allocation (SSA). The SSA is the most important determinant of return variability and long-term total return;
- Risk is an unavoidable component of investing;
- Diversification by asset class and within asset classes is a primary risk control element; and,
- Sufficient liquidity will be maintained to meet the anticipated cash flow requirements of the funds.

<u>Peer Total Return Rankings</u>. Figure 5 shows net-of-fees peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes better performance when compared to other public funds. These comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 92 public funds with more than $1 billion in assets. SIC notes not all of its investments report returns net-of-fees. In those cases, SIC's primary investment consultant (RVK) manually adjusts the returns by applying generic costs by asset class, a common practice performed by at least 95 percent of the funds included in TUCS. Because RVK does not have access to the active versus passive mix for any individual fund within the universe, SIC acknowledges in some cases the application of a generic fee could represent an inaccurate adjustment.

During the quarter, the return on the educational retirement fund and the land grant and severance tax permanent funds outperformed their peers by ranking in the top quartile; however, the public employee fund performed below their peers by being ranked in the 66th percentile.

Figure 5 - TUCS Universe Rankings
(public funds > $1 billion) For Period Ending 9/30/14



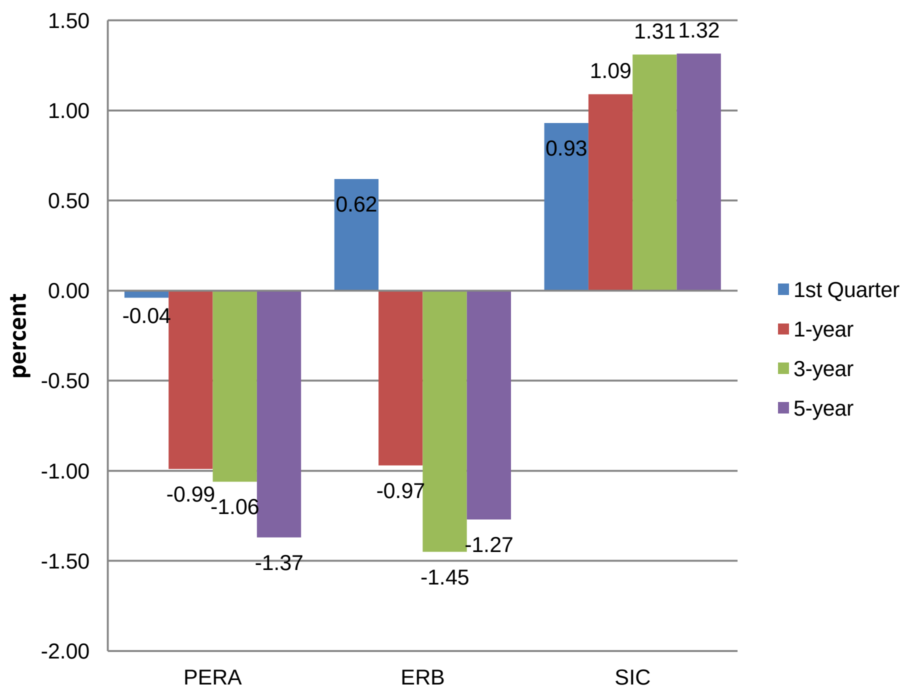
Staff from all three investment agencies acknowledges their respective performance rankings in the long-term are affected by limitations of their asset allocations at the time and by adverse economic conditions during the great recession. Therefore, before the agencies adjusted their investment policies toward more diversified portfolios through the use of alternative investments, the volatility of equity markets had a larger effect on their returns. As long as the investment agencies continue to meet or exceed their annual return targets in the short- and mid-terms, there is an expectation their long-term performance rankings will improve over time.

<u>Attribution Analysis</u>. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Policy Effect. A fund can have a long-term policy allocation target that has a more or less aggressive proportion of growth assets such as stocks. For instance, if return-seeking domestic assets such as U.S. stocks (equities) performed well during a period, an index that has more domestic equities should outperform the average. Measured in isolation against a defined peer group, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees based on investment mandate, need for liquidity and associated asset allocations.

Figure 6 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. (The investment agencies' policy target allocations are included in Figure 8, on page 9 of this report.)

Figure 6 - Quarterly, One-, Three-, and Five-Year Policy Effect (%) For Period Ending 9/30/14



PERA's policy index slightly lagged the median fund during the quarter. However, the policy index performed below the median fund by 0.99 percent, 1.06 percent, and 1.37 percent during the one-, three-, and five-year periods, respectively.

ERB's policy index performed 0.62 percent above the TUCS median fund performance during the quarter. However, the fund trailed the median fund by 0.97 percent, 1.45 percent, and 1.27 percent in the one-, three-, and five-year periods, respectively.

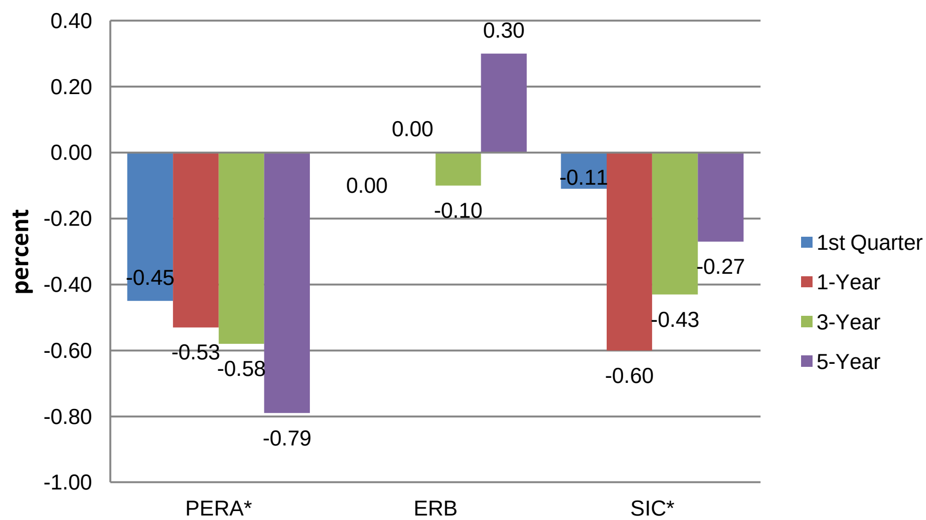
SIC's LGPF policy index performed 0.93 percent above the median fund in the quarter and 1.09 percent in the one-year period. The three- and five-year policy effects of 1.31 percent and 1.32 percent, respectively, are above the median fund performance.

Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes.

Because asset prices and values can vary in the short run, they can cause the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies allow some flexibility for the investment staff to operate within set boundaries. The three agencies constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause asset allocations to deviate from policy. In addition, new investment mandates can take years to implement (i.e. private assets). The chief investment officer may have the option of letting money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other vehicle, depending on policy authority. Rebalancing authority afforded to the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The investment return added or lost due to the difference between the funds' temporary and long-term allocation is known as the "allocation effect". Figure 7 shows the allocation effect graphically for the quarter, one-year, three-year, and five-year periods.

Figure 7 - Quarterly, One-, Three-, and Five-Year Allocation Effect (%) For Period Ending 9/30/14



* includes value of "other" for a net effect

PERA's asset allocation subtracted 0.45 percent from the investment return during the quarter due primarily to an underweight in real assets. For the one-year period, an overweight to international equities and underweights to real assets and liquid alpha subtracted value for a total allocation effect of negative 0.53 percent. Deviations from the target asset allocation detracted 58 basis points in the three-year period with an underweight in real assets and an overweight in international equities having the greatest negative effects. The five-year period shows a negative allocation effect of 0.79 percent.

ERB's allocation effect for the quarter and for the one-year period was zero while the three-year effect shows a loss of 0.10 percent, resulting primarily from value lost by deviation from allocation targets in alternatives and in domestic and international equities. Value added in opportunistic credit, risk parity, and in real estate offset losses in real assets and in international equity markets, contributing to ERB's allocation that added 30 basis points during the five-year period.

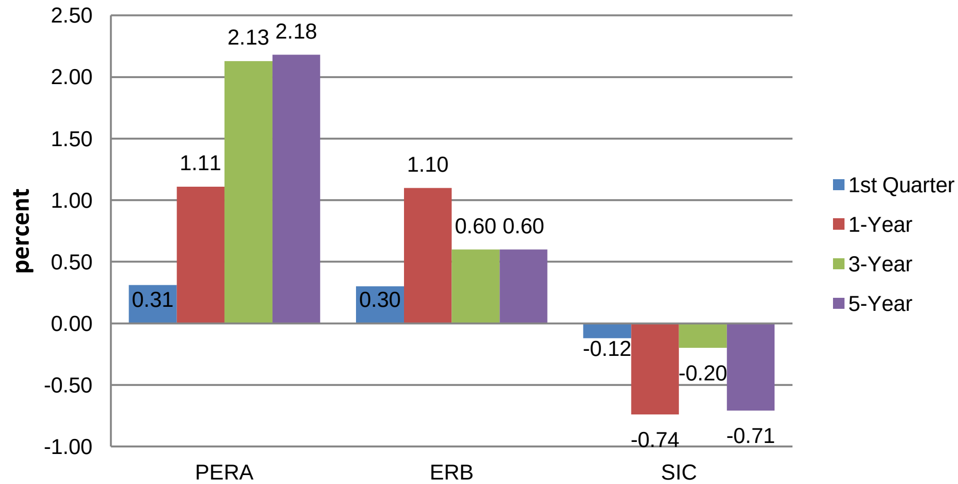
In the case of SIC and PERA, the attribution under "other" is manually added to the allocation effect for a net result. During the quarter, variance of the fund's actual allocation from SIC's policy weights subtracted 0.11 percent from total fund performance. The one-year allocation effect was negative 0.60 percent; value added by underweight to non-U.S. equity couldn't offset value lost from overweight to fixed income and cash equivalent assets.

Manager Effect. The third way that value can be added or subtracted from a fund's returns is through the use of active management. In this case, the agency can employ a manager who will trade individual securities given his or her perspective of individual stocks. This is known as "active" investing. The difference between the return of the index fund and the portfolio of the active manager is known as the "manager effect."

Figure 8 shows manager effects for all three agencies during the quarter, one-year, three-year, and 5-year periods. PERA's manager effect is 0.31 percent for the quarter. PERA's manager effect of 1.11 percent in the one-year period was largely realized through active manager outperformance in real assets and in fixed income. PERA's solid three- and five-year manager effects of 2.13 and 2.18 percent, respectively, were largely influenced by active management in fixed income and domestic equity. ERB's manager effect in the quarter was 0.30 percent. The one-year period shows a manager effect of 1.10 percent because of gains in private real estate, global tactical asset allocation (GTAA), and in opportunistic credit offset by losses in private equity, non-U.S. emerging market debt, and non-U.S. developed markets equity. SIC's manager effect[1] during the quarter shows a loss of 0.12 percent. The one-year manager effect is negative 0.74 percent as value added in fixed income and in real return was not enough to offset value lost primarily in private and U.S. equities. SIC notes their negative-0.71-percent five-year manager effect is influenced by previous managers and portfolio restructurings that have been in place by current staff for a short amount of time.

[1] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RVK.

Figure 8 - Quarterly, One-, Three-, and Five-Year Manager Effect (%) For Period Ending 9/30/14



<u>Passive vs. Active Total Portfolio Investment Management.</u> Chief investment officers consider using active managers or investing in an index in an effort to maximize risk-adjusted net returns. A measure of the ability to properly balance the active/passive investment decision can be seen in the *Manager Effect*. In doing so, they use the concept of "alpha" to measure the security selection against an actively-managed portfolio with a given benchmark. Alpha is the return in excess of a given benchark that is derived from manager skill. The objective when deciding to engage in active management should be to generate enough alpha to more than pay for the active management fees it costs to obtain. The active and passive distribution of all three investment agencies is described below using data as of September 30, 2014:

- Of PERA's $7.75 billion in public equities, $3.4 billion (44 percent) is actively managed. Further, of approximately $2.67 billion of PERA's alternative asset allocation, about $2.5 billion (94 percent) is actively managed. PERA's $3.78 billion fixed income portfolio is 100 percent actively managed.
- Of ERB's approximately $4.2 billion in public equities, $1.6 billion (38 percent) is actively managed; in contrast, of the $3.3 billion invested in alternatives, $2.6 billion (79 percent) is actively managed. Further, ERB actively manages its entire $3.6 billion portfolio allocated in fixed income assets.
- Of SIC's approximately $19.8 billion in assets between the LGPF and STPF, $15.3 billion (77 percent) is actively managed; of $9.8 billion allocated to public equities, $5.2 billion (53 percent) is also invested by active managers. Further, SIC actively manages its entire investment allocation in the fixed income and alternative asset classes.

<u>Other Investment Agency-Related News</u>

- During the quarter, PERA completed revisions to its investment policy statement, codifying the fund's new Strategic Asset Allocation (SAA), thus paving the way for the implementation of the fund's new targets approved in April. Theoretically and once fully implemented, the new SAA should increase returns while lowering the risk of the fund. This was accomplished by reducing the equity allocation, adding the fixed income plus allocation, increasing real estate, real asset, and private equity, and right-sizing the global equity allocation.

In connection with the new strategic asset allocation, PERA's board approved a plan to restructure the domestic equity portfolio, which will simplify the line-up and reduce risk while reducing fees by $3 million (pro forma).

PERA launched its cash equitization overlay claiming it will eliminate cash drag, reduce policy benchmark risk, and provide the agency with an additional rebalancing tool.

- The SIC announced that Deputy State Investment Officer Robert "Vince" Smith took top honors at this year's CIO Industry Innovation Awards, for representing the very best among institutional investors.

  The SIC also announced it has agreed to a $775,000 settlement recovery related to placement agent and investment manager Alfred Jackson over investments New Mexico made with him or his funds under the previous Governor's administration.

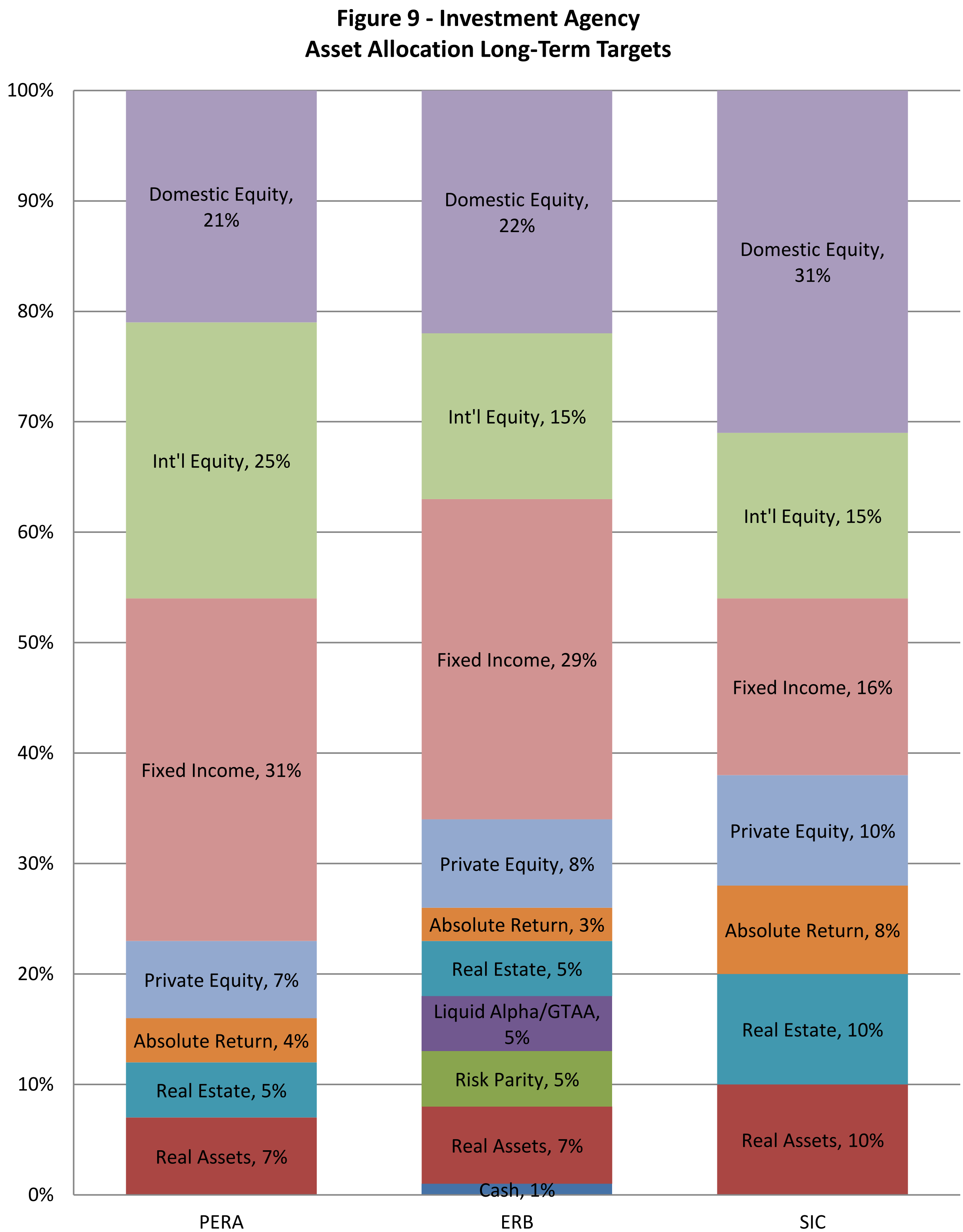


Figure 9 - Investment Agency
Asset Allocation Long-Term Targets
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Domestic Equity, 21%
Int'l Equity, 25%
Fixed Income, 31%
Private Equity, 7%
Absolute Return, 4%
Real Estate, 5%
Real Assets, 7%
Domestic Equity, 22%
Int'l Equity, 15%
Fixed Income, 29%
Private Equity, 8%
Absolute Return, 3%
Real Estate, 5%
Liquid Alpha/GTAA, 5%
Risk Parity, 5%
Real Assets, 7%
Cash, 1%
Domestic Equity, 31%
Int'l Equity, 15%
Fixed Income, 16%
Private Equity, 10%
Absolute Return, 8%
Real Estate, 10%
Real Assets, 10%
PERA
ERB
SIC